RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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Sept. 21, DJIA 13820.19; PTI 5956; A-D Ratio +40.11
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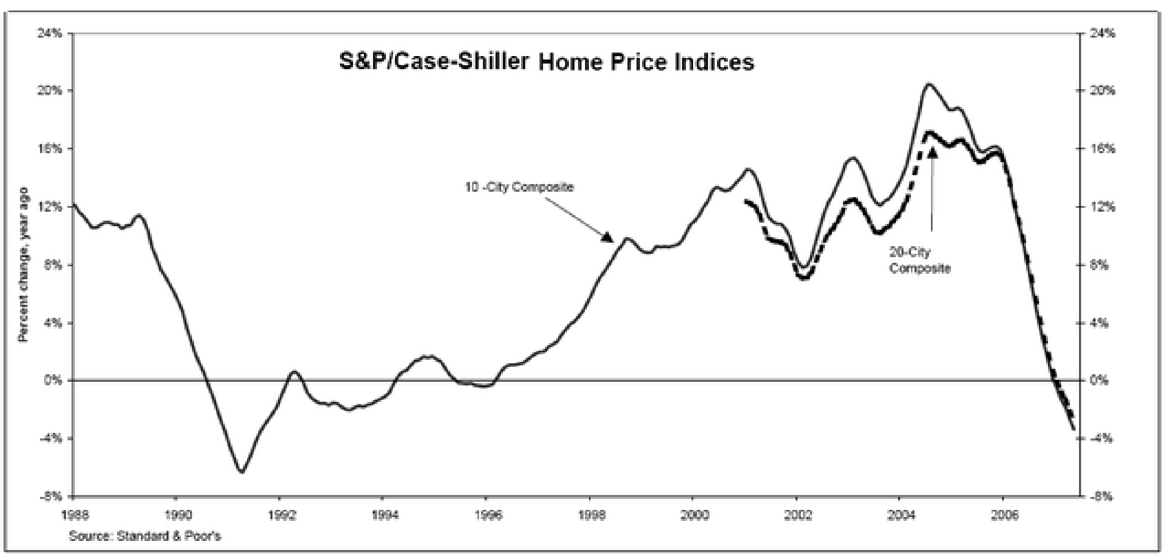
S&P Yield: 1.85% S&P p/e: 17.94
Gold 50-Day: 695.20

REAL ESTATE — The news on housing gets worser and worser. How bad can it get? Look, the simple fact, and I've been saying this for a long time, is that housing is just plain **overpriced.** Do you know when housing is reasonably priced? Housing is reasonably priced when you can buy a house, and then turn around and rent it out, and the rent will cover your costs, and I mean all your costs including mortgage, repairs, taxes, utilities, loss of interest on the money you put up to buy the house.

My father was in real estate all his life. He knew real estate backwards and forwards. And he had a formula. No matter how you cut it, no matter how you finance it, when you buy a house it's going to cost you an average of **ten percent a year** to hold that house. I've revealed this ten percent formula to a lot of people. They're usually skeptical at first. After a few years they tell me, "Yeah, Russell, you were right. The house is costing me an average of 10% a year including all expenses.



Today you buy a house for say $400,000. How you finance it is your business. Can you rent that house for $40,000 a year? Are you kidding? You're lucky if you can rent it for half that amount, which means that you're paying double what the house is really worth. A lot of seasoned old-timers are predicting a 40% or 50% drop in home prices. I don't know if we'll see anything near that drastic, but home prices in real estate bear markets tend to head south slowly, and I believe this decline in home prices could take anywhere from 18 months to two or three years.

Above you see the Case-Shiller chart of the trend of home prices. Prices are now accelerating on the downside. *Bloomberg.com* reported that values declined 3.9% in the 12 months through July, steeper than the 3.4% drop one month before in June. The index also fell in January for the first time since S&P/Case-Shiller started the measure in 2001, and it

has dropped every month since then throughout 2007. The home-building stocks are all hitting new lows. Typical examples are these two well-known builders to the right, and I believe Lennar is the nation's biggest, although it's clear that size hardly helps when it comes to the price of the stock.

Of course, the stock market knows all about the problems of the builders and the housing industry. What the stock market is trying to figure out is whether the US economy can prosper (let's say "just get along") with a sick housing industry (and a slowing auto business). Ah, that's the question, and it may take a while before the stock market makes up its collective mind.

STOCK MARKET (9/26/07)— The Dow still looks good, and, of course, so do the Diamonds (DIA). And yesterday the NASDAQ 100 actually hit a new high (thank you Sir Apple and Mr. Google). Nevertheless, yesterday I saw something I didn't care for. Lowry's Buying Power Index has been declining ever since its recent peak in mid-July. I haven't liked that action, particularly with the Selling Pressure Index holding above the Buying Power Index. Then yesterday, Lowry's Buying Power Index dropped to a new low for the move. In my experience, that's negative action. While Buying Power (the urge to accumulate stocks) is fading, Lowry's Selling Pressure Index remains well above the Buying Power Index. Remember, Lowry's statistics deal with the whole NYSE, not just the Dow.

Ordinarily, during rallies, Lowry's Buying Power Index leads the Dow. But despite the Dow strength, yesterday the Buying Power Index broke down. As I said, I take this as an indication of technical deterioration. On top of that, yesterday, new lows on the NYSE rose to 102. The new low series for the last five days is as follows — 18, 27, 34, 52, 102. This indicates increased selling pressure. A rising number of stocks are breaking down.

Against this, my PTI has been in a rising trend. Yesterday, my PTI closed at 5953, only 3 points under its high. At the same time, the Dow yesterday closed at 13778, 933 points above its August 16 low and only 22 points below its all-time high. There are times when all you have in this business is your instinct. I'm going to use my instinct now.

I think it's time to be rather cautious toward this market. We're in a very tricky area. I've said repeatedly that this is not an institutional market. It's more of a trader's market. And traders can reverse their opinion and actions at the drop of a hat.

I've been studying the action of the various stock averages for half a century. Yes, the Transports are lagging. And the S&P is actually below the peak it recorded seven years ago in 2000. I'm getting a bit nervous about this market. It's not one thing that I can put my finger on, but I'm watching those Lowry's figures. I'm watching the rising number of new lows, and I keep waiting for volume to expand on the days when the market is higher.

So let me put it gingerly. My instinct tells me that this is not a great time to be loaded with common stocks, and I hope I'm wrong. I think the best thing that could happen now is that the stock market would fluctuate within a trading range, while the main stock averages tend to hold **above** their August 16 lows.

Meanwhile, the Dollar Index is breaking down rather dramatically, as the purchasing power of the dollar deteriorates. I wonder whether that hasn't had something to do with the rising stock market or at least the rising Dow? A lot of people (particularly foreigners) don't want to hold a lot of dollars. One way of getting rid of dollars is to buy the cream of the US stock market and, of course, I'm referring to the Dow stocks.

What about other areas? I'm looked over my charts of the various commodities (I do this every day). It's taking more and more weakening dollars to buy a broad spectrum of goods. Soybeans and wheat are at the highs. Cattle, crude, heating oil, gold, copper, coffee and platinum are near the highs. Swiss francs, euros, Canadian dollars are at the highs. Rising trends in corn, sugar, silver, OJ, cotton and the British pound.

That seems to be the story as the dollar loses purchasing power. Of course, a sliding dollar is great for overseas tourists coming to the US. The place feels like one big candy store to them. The main street here in La Jolla looks like the United Nations. Every couple and their kids seems to be speaking a different language. Faye and I play a game when walking down Prospect Street. The game is called, "That couple we just passed — what language were they speaking?"

A deluxe dinner here in La Jolla may cost you fifty bucks plus wine and a tip. Try that in London or Paris or Moscow or Hong Kong. The same dinner will cost you three times as much, and the weather here is a lot better. So what are our foreign friends doing with all those dollars that are piling up in Europe and Asia? Simple, they're buying up the US, piece by piece. How now, Dow?

The piece below is one of the most important that I have presented this year. I just received and finished reading a paper by one of my favorite economists, Richard Duncan (he authored the terrific book, "The Dollar Crisis, Causes, Consequences, Cures"). Duncan is one of the very few people who fully understands what's going on in the US and world economies. So incisive is Duncan's view that I'm going to include the next two paragraphs from the latest Duncan paper. Please study these two paragraphs carefully.

"Bubbles are easier to inflate than to sustain. The US property bubble is now beginning to deflate, and the risks to the US and the global economy are greater now than they were when the stock market crashed six years ago — greater because the global imbalances have become so much larger as a result of the US property bubble. If US consumption now begins to contract, as appears likely, US imports will decline, and the world will also go into recession, possibly a very severe one.

"Credit growth drives economic growth. Total credit in the US as a percentage of GDP has grown from 150% in 1969 to 240% in 1990 to 340% today. It is not difficult to understand that rapid credit expansion boosts consumption and investment and employment and asset prices. However, excessive credit growth also eventually causes economic overheating and asset price bubbles. So long as additional credit is forthcoming everyone can simply borrow more this year to pay interest on the money they borrowed last year. Those bubbles pop when the individuals and/or corporations who borrowed the money are unable to pay it back. That is the situation we are experiencing today."

To rephrase some of Duncan's concepts, the crux of the problem is that the world has been in a huge bubble, brought on by the massive deficits of the US. The US current account deficit is now running at $800 billion a year, and these monster deficits have been exported (and financed) by the rest of the world accumulating dollars.

Now the world bubble (due to a number of causes and triggered by the subprime disaster) is beginning to deflate. This has created an international **credit crisis**. If the world bubble continues to deflate, it's going to result in a global recession or

worse. The only way to halt this deflation is for the US government to increase its ratio of debt to Gross Domestic Product (GDP). This will require the US to spend additional hundreds of billions of dollars — maybe well over a trillion dollars to offset the deflationary forces of the credit contraction. Richard Duncan believes that the US may have to spend a trillion dollars or more over the next four years just to stave off credit contraction and deflationary forces.

The question then arises, how can the US finance the huge amount of spending (debt) that must be created in order to offset the forces of deflation? The usual way would be to sell Treasury securities to our foreign friends and their central banks. But what if the central banks (already choking on US dollar-denominated securities) have accumulated enough dollars? In that case, the US will have to sell bonds to the Fed, and the Fed would create the money needed to finance the deficits.

But wouldn't this process be highly inflationary? Yes, of course it would — basically, it's monetizing the debt, which is always inflationary. Yet increased inflation is what is needed to counteract the deflationary force of the deflating world bubble.

The question then arises, assuming deflation can be held off, how can the whole mess be solved in some permanent way in the future? The answer, I believe, is that the world must move to a new monetary system with an anchor in something tangible, an anchor that will force discipline. The only tangible item I can think of that will fit is gold.

In the September 22 *New York Times,* the headline in the Business Section reads, **"Suddenly, Bush Speaks of Controlling Spending."** I stared at this headline. Is he serious or is this just another dizzy Bush fantasy? Cutting back on spending in the face of the already deflating asset bubble would (ironically) have deadly consequences.

But on the same day on the front page of the *Los Angeles Times* I read this headline, **"Budget for War Jumps in 2008. Bush Plans to Increase His Request to Nearly $200 Billion."**

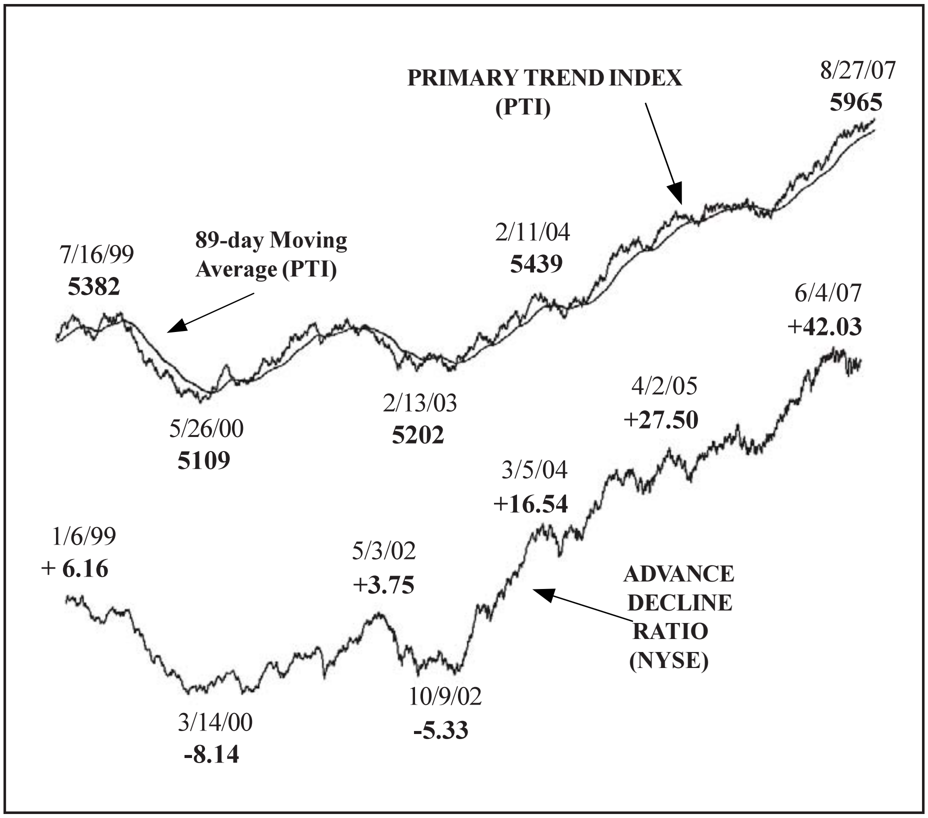
I just shook my head and looked skyward. Does anybody in the US government know what's going on? To spend? Not to spend? Why spend? Spend where? Washington is in a funk. Maybe Fed Chief Bernanke will see the danger of deflation, and roll out his helicopters.

In the meantime, investors, you and I, are in a quandary as to what to do and how to protect ourselves in a world that has gone slightly mad. It seems to me that our anchor of economic survival rests with gold. If the US is forced to produce massive deficits over coming years, those deficits will batter the dollar and at the same time they will put upward pressure on gold.

Stock Market — The action and direction of the stock market is a more difficult call. Will the market head higher as it deals with the needed massive deficits? Or will deflationary forces (assuming they win out) pressure the stock market to the downside? Here, surprise, I'm going to take a neutral stance. I am going to be guided to a large extent by the action of the stock market itself. So far, I'm sticking with the Dow, and to make it easy, I'm sticking with the ETF of the Dow which is the Diamonds (DIA). If the market is going to head higher, it will be led by the Dow.

Last Friday (9/21/07) the Dow closed 975 points ABOVE its August 16 low close. That was an impressive upside advance with all of it compressed into a period of one month. Some claim the advance was largely short covering. Others claim it was merely hedge funds jumping in for a trade in an oversold market.

In truth, there have been flaws in the rise. The Transportation Average was sluggish. The rest of the market outside the Dow was a laggard. As of last Friday, 70% of the stocks in the Dow were in bullish trends, but only 49.64% of the stocks on the NYSE were in bullish trends and only 54.20% of the stocks in the S&P 500 were in bullish trends. In other words, the stock market on the upside was really pretty much confined to the Dow.



Furthermore, volume indications were not that encouraging. The lack of volume suggests that the institutions were holding back to a large extent. They weren't joining the party.

Anyone who bought the Diamonds (DIA) at the time I suggested they do — now has a profit. But profits are only profits when they are taken. I'm going to watch the market action very carefully (what else is new?) with particular emphasis on the Dow. The 50-day moving average of the Dow now stands at 13424. If the Dow breaks below that level, I'll probably sell the Diamonds and move to the sidelines. The 200-day MA of the Dow stands at 12982. I certainly wouldn't carry the Dow below its 200-day MA.

IT'S UP TO THE GOVERNMENT— (Bloomberg) — Consumer spending in the U.S. rose more than forecast in August, suggesting Americans are as yet undeterred by a softening labor market and higher borrowing costs. The 0.6 percent rise in spending was the biggest in four months and followed a 0.4 percent increase in July, the Commerce Department said today in Washington. The Federal Reserve's preferred measure of inflation cooled.

Russell Comment — July and August consumer spending, impressive but it's also history. Things can change.

OK, I might as well tell you this — I've got this feeling. Call it an instinct, call it anything you want. My feeling is that the housing situation is starting to "kick in." By that I mean that housing problems, the housing slow-down, is starting to have an effect on the national sentiment. Two-thirds of American families now own their own homes. These home-owners have been feeling good for the last four or five years, because the price of their homes was increasing month after month, year after year. "Hey, Murph, I just checked the price of my house and all the houses on our block. They're up ten percent already this year. Did I tell you that I just bought a new Toyota?"

That's the way it's been going. Americans have been on a buying and consumption tear for the last four or five years. And why not, they had a gold mine in their homes. But not any more. Now the price of homes is leveling off and more probably heading down. That old happy feeling is now running in reverse. "Yeah, I was going to take the wife out to that new restaurant Saturday, but I think we're just going to eat home. She's a better cook than I thought, really knows how to make a hamburger."

Of course, I can't prove it, but that's the sentiment I'm sensing. And as I said above, I believe the "housing thing" is starting to work in reverse. They took away the punch bowl when the prices on housing started to fade.

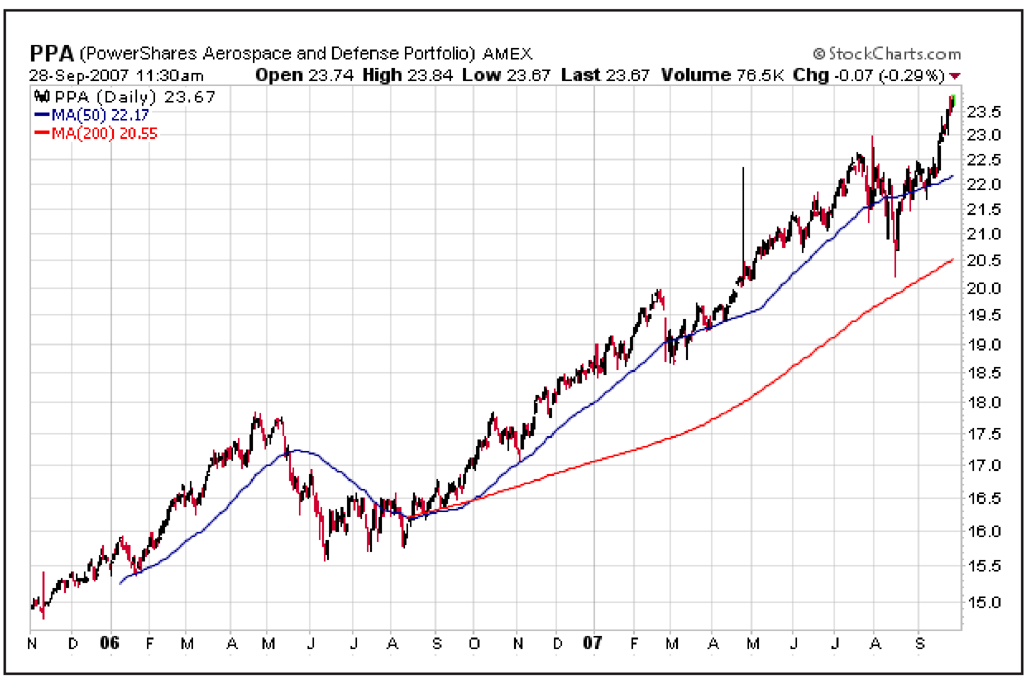
On top of that, this headline appeared yesterday (927/07) in the *Wall Street Journal* — **New Concern: Business Spending, Durable Goods Orders Fall. Investment May Be Losing Momentum."** The article starts, "Orders for durable goods such as computers and machinery tumbled in August, raising concerns that business spending may slow."

So where does that leave us? The consumer is slowing down, and business is cutting back on its spending. Here's where it leaves us — it now falls on our government to keep up the spending. I've been warning about this all along. Richard Koo in his book, "The Balance Sheet Recession," warned about this. With the massive amount of debt in this country hanging over us, with the monster current account deficits being run up every year, these are forces for **deflation.** To keep the US economy moving, there has to be BIG spending — and an expanding Gross Domestic Product. If the consumer isn't going to do the spending, if business isn't going to do the spending, then the government will have to do the spending.

Ironically, the politicians don't understand this. They all talk about cutting spending and moving toward "balancing the budget." If the US cuts spending and moves toward balancing the budget, we'll sink into the damnedest recession you've ever seen. Yes, it's ironic, but the US must now run bigger deficits than ever! It's now truly a case of "inflate or die."

Unfortunately, this will play hell with the already weak dollar. Huge deficits, lower interest rates, a weakish economy, they're all poison for any currency, and the dollar will be no exception. Who will benefit? The answer is that gold will benefit. When the dollar declines in value, it takes more dollars to buy an ounce of gold. In fact, it will take more dollars to buy diamonds, Picassos, top-grade collectibles, rare coins, objects of art, and so on. It will cost more dollars to buy anything of lasting tangible value.

What I particularly don't like about the whole picture is that this need for increased government spending makes it attractive to expand the military. It even makes it attractive to start something, like, well, like a war with Iran. Nothing calls for increased spending like a war, with its accompanying surge in war supplies, and I'm talking about the vital need for tanks, ships, planes, weapons, armor, and so on. This is a very cynical observation, but the people who run this nation (either party) are nothing if not cynical. Would they start a war just to "get things going"? Frankly, I wouldn't bet against it. Heck, we started a war with Iraq, and Iraq wasn't even a danger. Of course, I think Iraq has something to do with oil.



Remember this one? Customer to broker — "Gus, it's terrible out there. Dope is everywhere. People are shooting up on the street corners. I've never seen anything like it."

Broker — "Really? Listen, do me a favor, see if you can find out who manufactures the needles."

Along those lines I'm going to add PPA to my DIA and GLD recommendations. I've recommended this exchange traded fund before — this is the fund that contains aerospace and defense issues. PPA has been doing just fine, as you can see on the daily chart above. I think it's going to continue doing fine. Buy it now or buy it on any weakness.

Some say the business of America is business. But you can make a good case for a slight revision — the business of America is war; Korea, Vietnam, Iraq, Afghanistan. Hey, I wouldn't lie to you, we do a lot of wars.

Next Mailing: October 24, 2007